Bernard Schneider

April 15, 2013

The Honorable Devin Nunes
Committee on Ways and Means
United States House of Representatives
1013 Longworth House Office Building
Washington, DC 20515

The Honorable Earl Blumenauer
Committee on Ways and Means
United States House of Representatives
1111 Longworth House Office Building
Washington, DC 20515

Re: International Tax Reform—Income Tax Treatment of U.S. Expatriates

Dear Sirs,

I am writing with comments to the International Tax Reform Working Group on the subject of citizenship based taxation and the tax treatment of U.S. expatriates.

Personal Background and Basis for Contribution

I am a tax lawyer with a J.D. and a LL.M. in Taxation. I have worked for more than 10 years in the areas of U.S. and international taxation, first in New York and most recently in expatriate taxation in the United Kingdom. This letter serves primarily as a summary of the arguments made in my article on the subject of the taxation of U.S. expatriates. The full cite for the article is Bernard Schneider, *The End of Taxation Without End: A New Tax Regime for U.S. Expatriates*, 32 Virginia Tax Review 1 (2012). A Word version of the text is included with this submission; a PDF file of the article as published is available at http://ssrn.com/abstract=2186076. I respectively refer you to the article for a more complete, and footnoted, discussion of this issue.

The Current Situation

The United States is the only major country to tax its citizens and foreigners admitted as permanent residents (lawful permanent residents or "LPRs") (collectively "U.S. persons") on their worldwide income, regardless of residence.

Number of Expatriates

It is estimated that there are six to seven million U.S. citizens living outside the United States. This number undercounts the number of overseas individuals subject to U.S. taxation. It does not include an unknown and untracked number of LPRs abroad, who are still considered U.S. tax residents even though in many cases they have lost the right under the immigration laws to live in the United States. It also does not include an unknown number of individuals abroad who acquired U.S. citizenship by accident of birth in the United States, many if not most of whom have little connection to the United States ("accidental citizens"), and citizens by descent who were not registered as U.S. citizens and may not even be aware that they are considered U.S. citizens ("unaware citizens by descent"). Also directly affected are non-citizen spouses and children of U.S. citizens.

Due to globalization and increasing economic opportunity overseas, especially in Asia, the number of U.S. persons abroad can be expected to increase.

Tax Treatment

Generally, U.S. expatriates are treated like U.S. residents and taxed on their worldwide income. However, U.S. expatriates should be compared not to U.S. residents but to nonresident aliens. But for their citizenship or immigration status, U.S. persons abroad would be treated like nonresident aliens, i.e. generally taxed at a flat rate of thirty percent on U.S. source income that is not effectively connected with a U.S. trade or business and at the regular graduated rates on income that is effectively connected with a U.S. trade or business, including on gain from the sale of real property interests in the United States. In addition, net capital gains would not be taxable unless they are fixed or determinable annual periodic income. Needless to say, the foreign source income of nonresident aliens is not taxed by the United States. In most cases expatriates could engage in the same economic activities in the United States as nonresidents without paying the higher taxes for which residents are liable. The difference between the tax imposed on nonresidents and that imposed on expatriates constitutes part of the "citizenship penalty" paid by U.S. persons abroad.

In addition, expatriates are subject to problems that are caused or aggravated by foreign residence, including:

- Phantom gains from foreign exchange rate variations because they are required to calculate and pay taxes in U.S. Dollars instead of their functional currency;

- The complexity of the Foreign Tax Credit and the Foreign Earned Income Exclusion ("FEIE") and Foreign Housing Exclusion ("FHE") regimes;

- U.S. taxation of foreign retirement plans;

- The application of the Passive Foreign Investment Company rules to foreign mutual funds and other investment vehicles;

- Possible double imposition of social security taxes; and

- Filing obligations for interests in foreign entities (Form 5471, Information Return of US Persons with Respect to Certain Foreign Corporations; Form 8865, Information Return with Respect to Certain Foreign Partnership; and Form 8858, Information Return with Respect to Certain Disregarded Entities) that discourage investment by and with U.S. persons.

Two additional reporting regimes deserve special mention. The Foreign Bank and Financial Account reporting regime (the "FBAR" regime) imposes draconian penalties calculated in terms of account value, not unpaid taxes (if any), and often prevents U.S. persons from taking positions that involve signature authority over financial accounts. The Foreign Account Tax Compliance Act ("FATCA") regime is highly problematic due to its complexity, heavy-handedness,

extraterritoriality and unprecedented use of withholding to force disclosure of information. It has particularly serious consequences for expatriates. Some non-U.S. financial institutions have decided not to deal with U.S. citizens, and if the FATCA provisions are implemented as passed, more financial institutions can be expected to cease providing banking and other financial services to U.S. taxpayers, including U.S. taxpayers abroad.

Both these regimes were designed to cover U.S. domestic taxpayers and have been applied unthinkingly to expatriates. They treat foreign bank and investment accounts as inherently suspect, even though they are absolutely necessary for U.S. persons overseas. Expatriates live abroad for a variety of legitimate personal and professional reasons and should not be presumed to be tax evaders.

Analysis

Justification for taxation
There is little justification for the taxation of nonresidents:

- The overwhelming majority of expatriates receive few if any benefits from the United States while abroad.

- The right to move to or visit the United States without restriction is probably the only substantial benefit to long-term citizen expatriates and is the only one that is relevant to most accidental and unaware citizens, but it cannot justify worldwide taxation and is in any case no more than that enjoyed by the expatriates of other countries.

- Taxation can be justified if it is based on sufficient economic contacts with the taxing jurisdiction. In the case of long-term expatriates and accidental and unaware citizens, there generally is insufficient contact to justify worldwide taxation, most of which could have been conducted as a nonresident alien in any case.

- Individuals should be free to decide where they live and work without being treated like tax evaders.

Compliance
There is a high degree of noncompliance by nonresident U.S. persons with their U.S. tax obligations. Although the number of foreign returns is unknown because the Internal Revenue Service (the "IRS") does not track this information, probably only about a third of known U.S. expatriate citizens file returns. A 1985 estimate by the General Accounting Office (as it was then known) found that almost two-thirds of expatriates did not file, and estimates of the total number of foreign returns suggest that the majority of those who do file have a U.S. government affiliation. This low degree of compliance can be attributed to two factors. First, at least until recently, many expatriates were unaware of their U.S. tax obligations, and of course accidental and unaware citizens generally do not worry about U.S. tax laws. Second, there is a great deal of deliberate noncompliance, in many cases because the expatriates consider the worldwide taxation of nonresidents to be fundamentally unfair.

Enforcement

It is very difficult to enforce the worldwide taxation of expatriates. Except where income is reported to the IRS by a U.S. employer, foreign wage income information generally is not available to the IRS. Information regarding investment and other income is sometimes provided by foreign governments, but not necessarily in a form that is useful to the IRS. Investigating the tax affairs of most expatriate tax filers would be a time consuming and expensive process. Investigating nonfilers, most of whom are unknown to the IRS, would be extremely difficult. Thus, for nonresidents, particularly those with little connection to the United States, U.S. tax compliance is largely voluntary.

The Tax Gap

Given the problems with calculating the number of U.S. persons abroad and the lack of knowledge about the locations and average incomes per country of U.S. persons abroad, it is impossible to estimate the international individual income tax gap with any degree of certainty. Nonetheless, the IRS has estimated that four-fifths of U.S. taxpayers abroad owe no taxes. It is thus likely that the international individual income tax gap is small.

Renunciation of Citizenship

Expatriates are being driven to renounce their U.S. citizenship. According to the quarterly reports published in the Federal Register pursuant to Internal Revenue Code Section 6039G, only about 12,000 individuals have renounced their U.S. citizenship or relinquished their LPR status since those reports began to be published. These numbers are clearly an undercount. They do not include anyone not covered by Code Sections 877 or 877A and appear replete with processing errors. In addition, records issued by the FBI in connection with the National Instant Criminal Background Check System and reports by foreign governments suggest that the actual numbers are considerably higher. Furthermore, anecdotal evidence suggests that many U.S. citizens are "hiding" their U.S. citizenship by exercising another citizenship, by not registering their children as U.S. citizens and by taking other steps to limit their interactions with the United States.

Conclusion

Given the structural noncompliance, difficulties in enforcement, anger generated against the United States among both citizens and non-citizens and likelihood that there is little net revenue to be generated, the United States should stop trying and failing to tax its expatriate citizens.

Proposed Regime

Instead, the United States should enact a new tax regime for U.S. citizens and LPRs abroad:

- A Code Section 877A type departure tax would apply to those who take up or abandon U.S. tax residency, defined using either the bona fide residence rules or the substantial presence rules in Code Section 7701(b)(3). Under this approach, the Service would consider an individual to have disposed of most of his or her property at its fair market value on the day he or she emigrated or immigrated and then re-acquired the property for the same amount immediately thereafter. U.S. government employees and military personnel overseas would continue to be treated as U.S. tax residents.

- While nonresident, expatriates would be treated like nonresident aliens. They would cease to file returns on foreign source income, and their U.S. source income would be subject to withholding at source. Tax and financial reporting requirements, including those related to the FBAR and FATCA regimes, would not apply.

- LPR would be checked every 5 years for compliance with the requirements of the immigration law for maintaining permanent residence, and those who ceased to be permanent residents would be subject to the departure tax regime.

- The existing Code Section 877A exit tax on renunciation of citizenship and loss of LPR status by long-term LPRs could be eliminated. In any case, it could be expected to become largely a dead letter.

Advantages of Proposed Regime

There are many advantages to the proposed regime:

- It would make the U.S. tax system more equitable by correlating the payment of taxes to the United States with the receipt of benefits from residence in the United States.

- It would place U.S. expatriates in the same tax and competitive position as other expatriates.

- It would end the costly and largely futile attempt to enforce U.S. worldwide taxation against nonresidents.

- It would simplify U.S. tax law by eliminating the FEIE and FHE regimes and ending the application of the FBAR and FATCA regimes to nonresident U.S. persons.

- It would end the embarrassing situation of U.S. citizens seeking to renounce or hide their U.S. citizenship.

- It would eliminate the anomalous existence of "permanent residents" who no longer live in the United States.

I would be pleased to respond to any questions you may have.

Very truly yours,

Bernard Schneider
Enclosure